FRONTIER MARKET
ASSET MANAGMENT

Misunderstandings in the Frontier[1]

By Larry Speidell
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""It's not what you don't know that'll hurt you,
It's what you know that ain't so..."
– Will Rogers

The difference between expectations and results determines our level of satisfaction. This is true in life – and in investments. We are pleased when results exceed our expectations. And the surest way to disappoint investors is to promise high returns and then fail to deliver.

In seeking investment opportunities, the challenge is to look beyond the consensus view, by searching for companies that others have disregarded. That is where the surprises are more likely to be positive. By contrast, the more risky stocks are likely those that are "priced to perfection".

Frontier markets present a good opportunity to capitalize on positive surprises, because most investors are prone to three misunderstandings about the frontier:

They misunderstand frontier growth.
They misunderstand frontier risk.
And they misunderstand frontier liquidity.

With time, we believe investor perceptions will change, and the result of this improved understanding will be rewarding returns for early adopters of frontier investing.

Misunderstanding # 1 - Growth

In an interview on CNBC, I once spoke about the high growth in Africa resulting from better politics and economic development, supported by the demographic dividends of education and better healthcare. Only when the television engineer showed me the clip afterwards, did I see that on the screen behind me were projected images of poor Africans in rags shuffling down dusty roads in search of water. While these images are sadly true in parts of Africa, they obscure the dramatic growth and progress in Africa and other frontier markets - which is appreciated by very few investors. This high growth is shown in the IMF data and estimates below:

[1] Based on comments to the Elkind Emerging Markets Forum, Dallas, Texas, May 7, 2014

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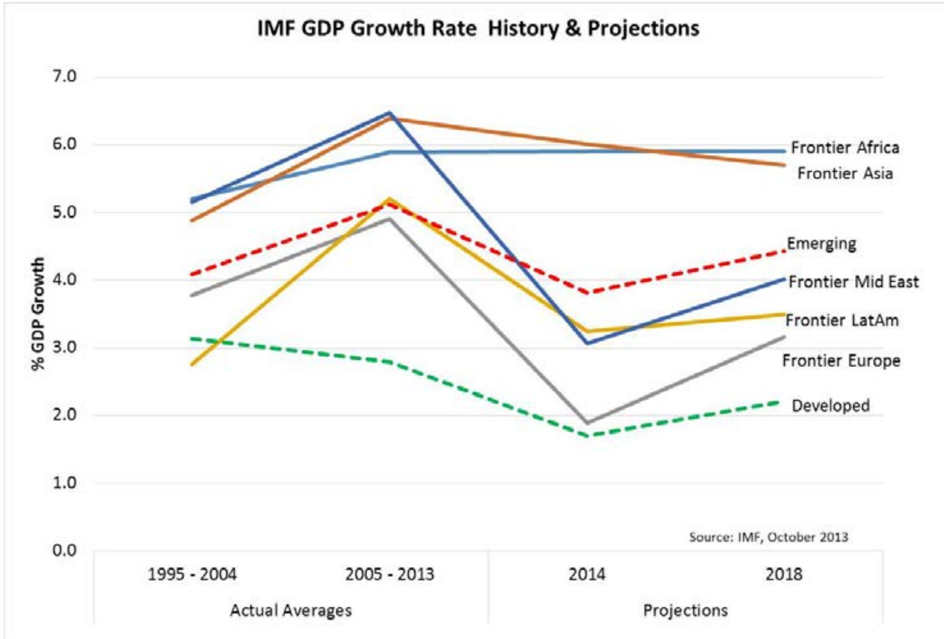
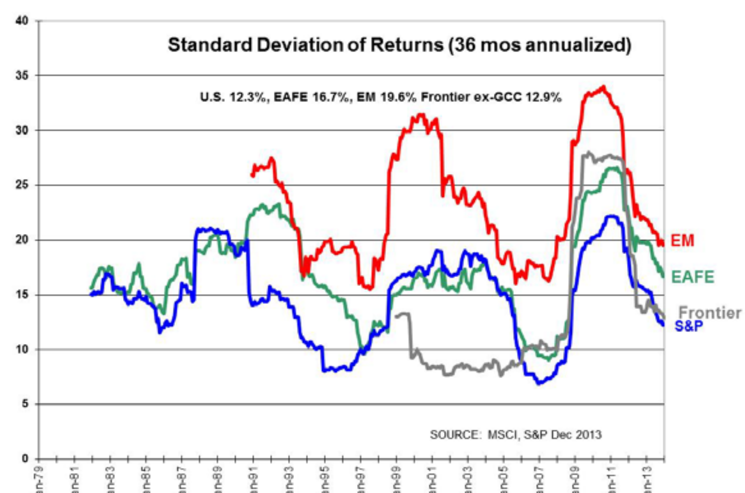


Source: IMF, October 2013

We believe that this high growth will trickle down to all the people in most frontier countries because business ownership is typically less concentrated than in some developing markets (such as Russia, where the oligarchs capture to much of the country's wealth). Frontier countries are breaking out of the cycle of poverty and following the path that many emerging markets has been on for more than a quarter century. Furthermore, we expect this high growth to translate into investment returns due to low valuation multiples in the frontier (compared with rich valuations that have diluted returns for the Asian Tiger countries like Taiwan and South Korea).

Misunderstanding #2 - Risk

Most investors view the frontier as more risky than emerging markets. The evidence suggests otherwise. As shown below, the standard deviation of a diversified portfolio of frontier markets is hardly different from the S&P 500 and is far lower than EAFE and emerging markets. (The chart below uses the IFC Frontier Composite of 21 frontier countries, which became the S&P Frontier ex-GCC Index in 2007.)

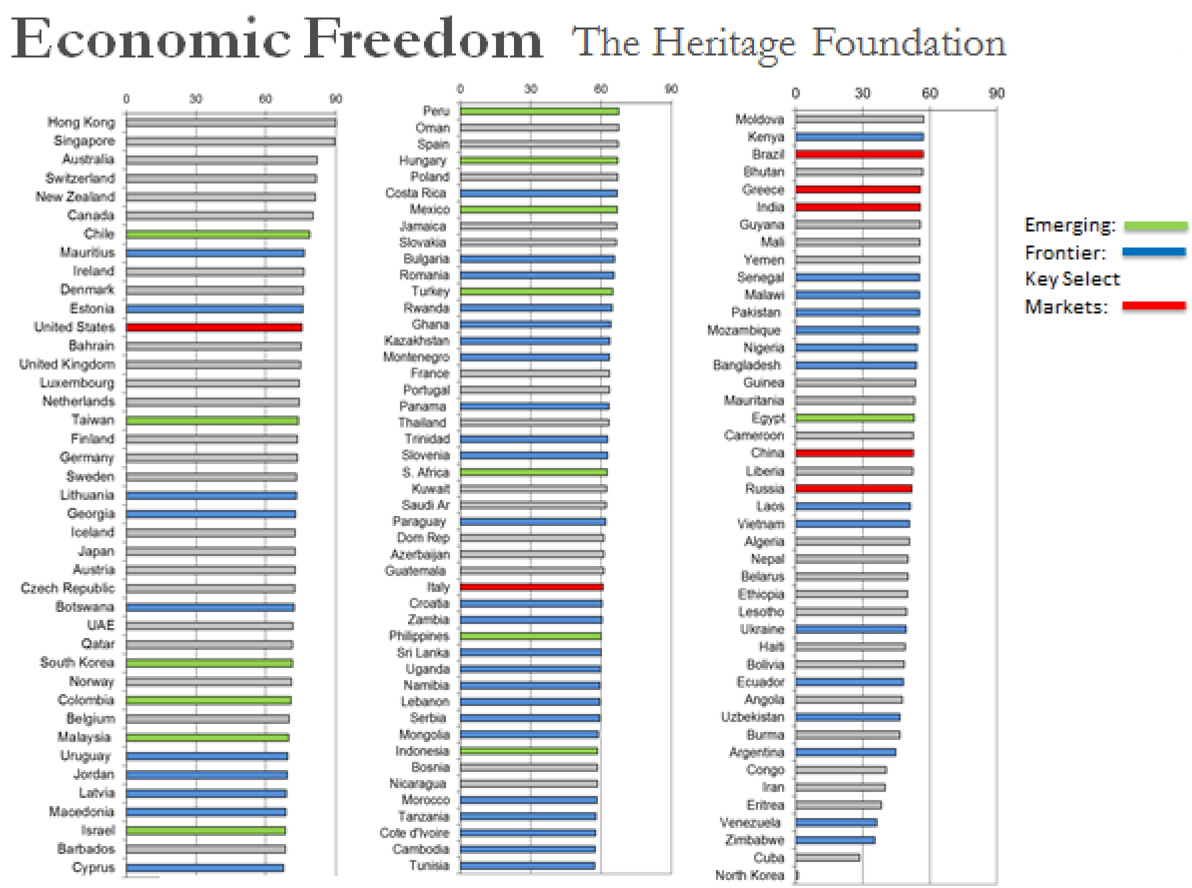


Correlations with:	Bangladesh	Botswana	S&P
Argentina	(0.06)	0.50	0.28
Bangladesh	1.00	0.08	(0.21)
Botswana	0.08	1.00	0.17
Bulgaria	(0.12)	0.48	0.35
Cote d'Ivoire	0.29	0.34	0.29
Croatia	0.22	0.44	0.22
Estonia	0.07	0.63	0.31
Ghana	0.07	0.42	0.34
Jamaica	0.19	0.04	(0.07)
Jordan	0.42	0.25	0.01
Kazakhstan	(0.18)	0.35	0.45
Kenya	(0.03)	0.34	0.49
Latvia	(0.01)	0.47	0.43
Lebanon	0.16	0.42	0.17
Lithuania	0.01	0.58	0.25
Mauritius	(0.01)	0.30	0.42
Nigeria	0.05	0.08	0.43
Pakistan	0.30	(0.20)	0.12
Romania	0.08	0.44	0.34
Slovak Repub	0.64	0.50	0.16
Slovenia	0.18	0.50	0.11
Sri Lanka	0.05	0.19	0.26
Trin. & Tobago	(0.13)	(0.28)	(0.06)
Tunisia	0.57	0.11	(0.20)
Ukraine	(0.06)	0.39	0.49
Vietnam	0.23	0.02	0.17
Zambia	(0.13)	0.04	0.23
Average (ex 1.00)	0.11	0.29	0.22

Source: S&P 36 mos Nov 2013

The secret to this low standard deviation is the low correlation of frontier markets among one another. The table above shows the average correlation of markets with Botswana is 0.11 while the average correlation with Bangladesh is 0.29. These markets are currently dominated by local retail investors who care most about local, not global, events.

Of course, we do not believe that risk as simply determined by standard deviation. For a more holistic assessment of risk, we recommend the Economic Freedom ranks of The Heritage Foundation, which are based on ten factors, including corruption ranks from *Transparency International* and Ease of Doing Business measures from the *World Bank*. As shown in the chart below, these ranks indicate that frontier markets are similar to emerging markets (in green) and that most of the frontier ranks higher than China, India and Russia (in red).



The Heritage Foundation 2014

Misunderstanding #3 – Liquidity

"You can't always get what you want"
<u>Let It Bleed</u>, Rolling Stones, 1969

Investors want it all: high returns and high liquidity. In quantum mechanics, the Heisenberg Uncertainty Principle states that you cannot measure the position AND the momentum of a particle. You can have a measurement of one or the other but not both. Investing works the same way. For alpha, you need inefficiency. But a liquid market is an efficient market. The more players that are involved in trading a stock, the more liquidity there will be. But more players means that more knowledge is being focused on price determination, and potential alpha will diminish. A friend described our process as buying "today's prices and *tomorrow's* liquidity". This approach requires patience and a long term horizon. It requires careful due diligence, both in stock selection and in asset allocation. One needs to pick the right stock, and one needs to stick with it. Since the days of Graham and Dodd, portfolio turnover in the investment industry has soared, and liquidity has soared - yet alpha generation has deteriorated. Perhaps it is time to return to the old ways. As an E.F. Hutton ad once proclaimed: "We make money the old fashioned way."

Conclusion

In *Grand Strategy*, Financial Analysts Journal, August 2013, Charlie Ellis wrote:

> "Sun Tzu said, 'The skilled commander takes up a position so he cannot be defeated. Thus a victorious army wins its victories *before* the battle.' Likewise, today's best investment strategists deploy their portfolios in a way that will achieve superior long-term results *and* withstand the severe interim tests of disruptive markets without the need to depend on clever tactics."

Our strategy is based on the belief that with time, the misunderstandings of investors will change. Portfolios deployed today in the path of that change will survive and will, we hope, prosper.

About Frontier Market Asset Management

Founded in 2006, Frontier Market Asset Management holds more than 35 years' worth of investment experience including work in Emerging and Frontier Markets since 1987. For more information, please contact us at (858) 456-1440.

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